



**Directorate of  
Intelligence**

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# China: A Look at 1987

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**Background Papers for the US Delegation  
US-PRC Joint Economic Committee  
16-18 November 1987**

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**Background papers for the US Delegation  
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**DIRECTORATE OF INTELLIGENCE**

23 October 1987

**China: The Political Year in Review** [redacted]

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**Summary**

The past year has been a turbulent one in Chinese politics, punctuated by the student demonstrations last December, the dramatic fall from power of party General Secretary Hu Yaobang in January and the subsequent surfacing of sharp differences over reform policies. Hu's downfall left Deng Xiaoping's succession plans and power-sharing arrangements in disarray. Both reformers and their more conservative critics among party elders have worked hard since then to gain the upper hand, seeking to put their stamp on the outcome of the 13th Party Congress now scheduled to open 25 October. This sparring, however, has been largely inconclusive. As a result, we expect the congress to end in a standoff. Although Deng is likely to gain some key personnel changes, including the installation of Zhao as party General Secretary, and an ideological document endorsing market-oriented reforms, we believe the conservatives will hold their own. Indeed, the reformers appear to have conceded that they will not be able to introduce any new systemic

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changes, such as price reform in 1988. Whether the reformers eventually regain the initiative will depend heavily on how well Zhao does in his new role as party leader. [redacted]

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Thus far, the infighting has not spilled over into the conduct of China's foreign policy, which enjoys a broader consensus. Beijing therefore will probably continue to seek better relations with both Moscow and Washington to enhance China's security and bolster its modernization drive. In response to Gorbachev's efforts to court Beijing, the Chinese increased political as well as economic contacts last year with the Soviets and even agreed to resume Sino-Soviet border talks, which had been suspended since 1978. But on balance, China continues to maintain friendlier relations with the United States than with the Soviet Union, exemplified by strengthening military ties that included last fall's US naval port call to China--the first since the present government took control. [redacted]

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### Domestic Politics

China's reformers were riding high early last year after scoring impressive victories over their conservative opponents, but a combination of political miscalculations and economic problems subsequently sapped the political strength of the reformers and slowed the pace of reform. The early hopes of some of the most progressive reformers that major political reforms would be undertaken have evaporated in the face of strong resistance from party elders and in the wake of the fall from power of party General Secretary Hu Yaobang. [redacted]

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Friction between conservatives and reformers mounted throughout 1986 over a broad range of issues--political reform, ideology, economic policy, succession arrangements, even patronage jobs. We believe the reformers overreached last year when they had the upper hand, miscalculating the strength of the conservatives and badly underestimating the alarm and opposition that aggressive reform policies would arouse. The crucial miscalculation apparently occurred in late summer, when Hu Yaobang pressed Deng and other party elders to step down and make room for their successors--including, of course, Hu. These tensions were reflected in a document on ideology issued by a party plenum in September. Not only was the document issued without the usual claims of unanimous agreement, its contents were an uneasy marriage of reformist and conservative doctrine. [redacted]

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Issues of both policy and power continue to separate the two camps:

- **Party control** is at the heart of many policy quarrels. Conservatives fear that some reform proposals threaten the party's dominance and even its ability to guarantee political and social stability.
- **Ideology** remains a contentious area, with conservatives arguing that some reformist suggestions--for example leasing or selling small industrial enterprises to individuals--not only would weaken party control but are an unacceptable departure from socialist doctrine.
- Disagreements over **succession arrangements** have heated up as Deng has lost confidence in the younger leaders. Party elders, reluctant to give up their positions, have argued that it would be unwise for Deng--and themselves--to completely retire and turn power over to a new generation.
- **Personnel appointments** have been a source of friction; conservatives resented Hu's success in monopolizing patronage and freezing out their supporters. Since January, conservatives have succeeded in getting some of their candidates appointed to key jobs. [REDACTED]

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Conservative criticism of reform policies received a boost when reformers encountered problems in the economic area--inflation, a growing budget deficit, foreign exchange shortages--that forced a slowdown in implementation of economic reforms. Conservatives had warned against some of these problems, which lent weight to their arguments that reform had moved too fast and it was time to retrench. Moreover, the student demonstrations in December, which were encouraged by the liberal rhetoric of the spring, aroused fears of instability and lent credence to conservative arguments that excessive liberalization was undermining party control. [REDACTED]

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The marked conservative shift has been moderated somewhat since last May. We believe the turning point came when some conservative leaders overplayed their hand and attempted to push the "anti - bourgeois liberalization" campaign into the economic sphere. Deng moved against this threat to his reforms, and the balance began to shift. Ideological pronouncements once again praise reform and promise continued experimentation, but they are still careful to stress the socialist nature of reforms--providing an opening for conservative pressure. [REDACTED]

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Recent evidence indicates that Deng and his allies have had to settle for a patchwork of compromises that includes a Politburo younger in average age but evenly balanced between reformers and conservatives. While reformers have made some gains in staffing party organs, conservative influence on economic policy making has increased. Political structural reform--a reformist code term for further reduction of party influence over government and economic decision making--seems stalled at the "general discussion" stage. In the months after the congress, we look for continued tensions and jockeying for power as leaders, including recently "retired" party elders, seek to consolidate their positions and press their advantages. [REDACTED]

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Perhaps the single most important issue will be how Zhao Ziyang proves himself in his new position as party head. Zhao has many advantages--he is respected by both sides, has a generally successful record as premier, and has a personal political style much better suited to Chinese politics than was the abrasive Hu Yaobang's. He also has Deng Xiaoping's support, crucial to his success but a two-edged sword--he will have to find a way to establish himself as heir without alienating Deng. On the down side, Zhao is constrained by the continued influence of powerful conservative elders; he also has a decisionmaking machinery not entirely of his own choosing and not entirely in sympathy with his ideas. Ironically, this is especially true in economic policy bodies that Zhao once dominated. Finally, Zhao as party chief must deal with sensitive and messy issues such as the party's role under reform, or the ideological legitimacy of progressive economic proposals, that, as premier, he generally tried to avoid. If Zhao successfully manages the next few months, however, the long-term advantage is with him, in our view, as age will erode the ranks of prestigious party elders.

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### Foreign Policy

As long as Deng Xiaoping remains in charge, we do not expect any sudden, dramatic changes in China's foreign policy. Deng and Zhao have gone to some pains since Hu Yaobang's ouster to reassure Western governments and investors on that score. In general we believe China will continue to tout its "independent foreign policy" line while seeking better relations with both Moscow and Washington.

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Despite Gorbachev's increased efforts to court Beijing, Chinese leaders probably will continue for both economic and security reasons to seek stronger ties to the United States. Indeed, Beijing still regards the United States as an important strategic shield against Soviet military pressure as well as a key market for Chinese exports and source of investment capital and technology. No single element better illustrates the qualitative difference between Sino-Soviet and Sino-US relations at present than the strengthening military ties between Beijing and Washington. Over the past few years, senior Chinese and US military officials have exchanged numerous visits. Last year was marked by several particularly important events, including the exchange of visits by China's Chief of General Staff and Secretary of Defense Weinberger. China also contracted for 55 fighter avionics packages for \$500 million and \$2 million worth of artillery-locating radars.

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The resurgence of conservative influence, however, may have some influence on Sino-US economic relations. Beijing, for example, could adopt a more selective approach to joint venture schemes with Western firms as well as a more restrictive policy toward allowing Chinese students to study in the West. The Chinese may also turn more to the Soviets and East Europeans for equipment and services, in part to save scarce foreign exchange, and may become more prickly in general on trade issues. The conservatives could conceivably press for some retaliatory action, for example, if the US Congress enacts strong protectionist measures that cut Chinese textile exports to the United States--an increasingly important earner of foreign exchange. The conservatives could also seize on the sharp drop in new foreign investment last year--US investment alone dropped by about half--to attack some reform policies.

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[redacted]

In any case, we expect Sino-Soviet trade and scientific and technical exchanges to increase. Trade in 1986 shot up to an estimated \$2.4 billion, and the Soviets have agreed to renovate 17 Chinese factories and construct seven new facilities--most in northeastern China--that probably will lead to several hundred Soviet technicians going to China. Overall, however, the Soviet Union remains a distant sixth among China's trading partners, well behind Hong Kong, Japan, the United States, and West European states, which account for over 80 percent of China's trade. [redacted]

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Although the Sino-Soviet political dialogue has similarly expanded to include border talks (suspended in 1978), the Chinese continue to take a cautious approach to Soviet overtures--in part to avoid alarming the United States and its Western allies as well as Japan. As a result, they continue to emphasize the need for Moscow to adopt more accommodating policies on the "three obstacles"--Moscow's support for Hanoi's occupation of Cambodia, the Soviet invasion of Afghanistan, and the Soviet military buildup along China's northern border--which Beijing continues to define as threats to its security. The Chinese remain adamant that Moscow withdraw its support for Vietnam's occupation of Cambodia. At the same time, they continue to support the Cambodian insurgents as well as the Afghan rebels as a means of keeping the Soviets and their allies on notice. The Chinese also continue to press Washington to initiate a dialogue with North Korea to limit Moscow's ability to exploit tensions on the peninsula. [redacted]

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Finally, China's relations with Japan have been strained over the past several months. The Chinese have charged that Japan is following a "two Chinas" or "one China, one Taiwan" policy, rekindling militarism, and persisting in unfair trade and technology restrictions. Beijing may cool its rhetoric, but has already begun diversifying its trade and foreign borrowing to Japan's disadvantage. [redacted]

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**DIRECTORATE OF INTELLIGENCE**

23 October 1987

**China's Economy: Policy and Performance in 1987** [redacted]

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**Summary**

Much of China's economic reform program has been stalled this year by political infighting and economic problems. Hu Yaobang's ouster as party General Secretary last January weakened the reform coalition, and conservative party officials took advantage of reformers' disarray to press for a less ambitious policy agenda that emphasizes greater reliance on central planning. Although China's economy has grown rapidly in 1987, rising prices and financial deficits have undercut reformers' ability to justify new market-oriented policies. Despite recent public assertions by Deng Xiaoping and Acting General Secretary Zhao Ziyang that Beijing will quicken the pace of economic reform later this fall, we believe that Chinese leaders have agreed to a cautious, lowest-common-denominator policy to improve enterprise performance. Therefore, price and several other key reforms are likely to remain stalled. [redacted]

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### Intense Policy Debate

Contention over economic policy in China has been intense since Hu Yaobang was forced to resign in January. The Chinese media this year have aired sharply divergent views on economic policy which, we believe, reflect deep divisions among China's senior leaders over the extent and pace of market-oriented reforms. For several months following Hu's ouster, for instance, the press highlighted statements by conservatives asserting the importance of the party in economic decision making in factories and advocating "plain living and arduous struggle" by workers to build a modern China. These officials also reportedly attacked as "capitalist" such reforms as reducing central planning, selling stock in state enterprises, leasing factories to individuals, and allowing rural income disparities to widen as peasants take advantage of increased autonomy over planting decisions. Beginning in May, reformers counterattacked, arguing that China's low level of economic development justifies an increased role for private enterprise. [REDACTED]

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### Mixed Economic Performance

Accounts in the Hong Kong media indicate that China's uneven economic performance so far this year has fueled the debate between reformers and conservatives. Industrial output has increased at a 15-percent annual rate--reflecting strong growth in key sectors such as electricl-power generation and steel, and double-digit growth for consumer durables including refrigerators, bicycles, and color televisions. Growth has been spurred by a surge in investment spending by state enterprises. Competition for raw materials for industry and demand for consumer goods, however, have outstripped supplies, pushing prices up at an 8-percent annual rate in June--high by China's standards. Moreover, the Chinese press has noted that product quality remains poor and inventories of unsalable goods continue to rise. [REDACTED]

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To complicate matters, increased investment and wage payments are contributing to the declining profitability of state enterprises--Chinese statistics show enterprise losses rising at about a 25-percent annual rate, and more than one-fifth of state-owned industrial enterprises have recorded deficits this year. Increased state subsidies, to deficit enterprises will push the government budget deeper into the red. [REDACTED]

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Economic performance in the countryside has bolstered reformers' arguments to some degree, because the output of nonstaples and rural industries has increased rapidly this year. However, Beijing's deliberate efforts to diversify agriculture--allowing peasants to sell vegetables and meats at higher prices and to leave farming to start rural businesses--have dampened peasants' interest in growing grain. This year production of grain--a politically critical staple--will fall far short of its 3.5-percent growth target, according to the Chinese press. [REDACTED]

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News on the foreign trade front is equally mixed. Beijing has continued last year's effort to trim the foreign trade deficit, slashing it by almost 70 percent in the first 9 months of 1987. Although central government holdings of foreign exchange increased

modestly to more than \$3 billion by midyear 1987, they remain well below the \$12 billion level Beijing recorded several years ago. [REDACTED]

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### **The Conservative Critique**

Conservatives have cited China's inflation, excessive investment, budget deficits, and foreign exchange shortfalls to criticize reformers for economic mismanagement, arguing that relaxed central controls are responsible for the economic dislocations. They are probably particularly alarmed by State Statistical Bureau figures showing that China's inflation rate has increased each month since April. Conservatives may argue that social stability is jeopardized because living standards for about one-fifth of urban workers have fallen this year; wage gains for some workers have not kept pace with inflation. [REDACTED]

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Conservatives are correct in believing that by relaxing central controls Beijing has increased inflationary pressures. Since the early 1980s, Beijing has broadened enterprise autonomy--particularly by allowing state factories to retain a larger share of their revenues and permitting them to sell overquota production of industrial goods at "negotiated," above-plan prices. However, it has not implemented effective measures to make enterprise managers accountable if funds are used inefficiently. [REDACTED]

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Judging from past responses to economic problems, we believe conservatives want to strengthen administrative controls over economic decision making and increase reliance on central plans. Conservatives would also like to lessen enterprise discretion over investment, and tighten controls over prices, wages, land use in the countryside, and foreign trade. [REDACTED]

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### **Reformers' Response**

Since market-oriented reforms were launched in 1979, proponents have overridden the practical and ideological objections of conservatives by arguing that monetary and fiscal policies can guide the economy when central controls are relaxed, and by insisting that reforms be judged by their ability to produce results rather than by their conformity to dogma. Consequently, reform leaders have been vulnerable to conservative criticism when the economy has performed poorly. It is thus no coincidence that in recent weeks reformers have orchestrated an intense media barrage to deflect attention from the conservatives' critiques, recounting improvements in the standard of living, economic growth, product variety, and other reform successes over the past eight years. [REDACTED]

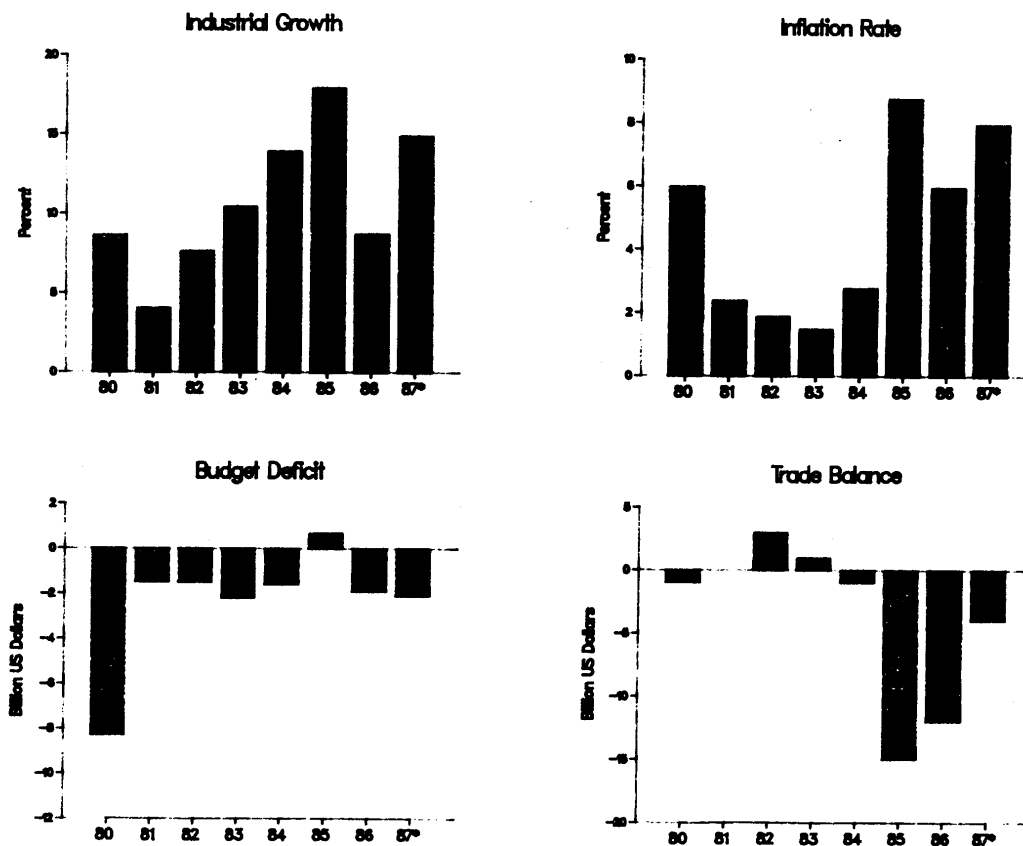
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While conservatives argue that the economy's problems derive from the fast pace of reform, reformers believe that dislocations result--in part--from piecemeal implementation. For example, reformers argue that Beijing should substitute the threat of bankruptcy for the certainty of state subsidies to motivate enterprise managers to control investment spending and wage increases. To reformers, more policy flexibility--not greater central control--is the appropriate long-run solution to economic problems. [REDACTED]

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## China: Economic Trends, 1980-87



\* Estimated.

Political infighting this year, however, has prevented reformers from effectively using monetary and fiscal policies to ease inflationary pressure. Beijing has been unable, for example, to stop spending by local governments on low-priority construction projects, such as hotels and municipal halls:

- Branches of China's central bank are ignoring head-office directives to limit credit and continue to fund whatever projects local officials want.
- Previous reforms gave local governments a greater share of tax revenues, making them less dependent on funds from central coffers.

### **The Clampdown on Prices**

According to Hong Kong journals and diplomatic reports, since the early 1980s China's top leaders have feared the sort of public uprising that occurred in Poland when food price hikes contributed to the growth of the Solidarity trade union movement. With the release of the economic performance statistics for the first half of the year and the ensuing debates about policy, senior leaders decided to implement an across-the-board freeze on prices and to tighten restrictions on investment spending. Chinese press reports indicated that the price freeze was in response to widespread consumer complaints about rising prices, particularly of food:

- In late August, Beijing ordered prices of consumer goods, including foodstuffs, frozen for the remainder of the year. To accomplish this, it authorized local governments to set price ceilings on farm produce sold at village markets and on overquota production of industrial goods--thus retreating on recent policies that allowed sales at negotiated prices.
- Beijing announced that only capital construction projects already approved by the central government may be started in the second half of this year. And if locally funded investment spending exceeds the targets set earlier this year, the excess will be deducted from next year's target and responsible officials will be disciplined.
- Enterprise managers were ordered to keep wage increases from exceeding the growth of industrial productivity--now trailing wage gains by one-half.

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Leaders who are counting on local officials to carry out broader reform objectives have rejected proposals to restrict provincial control over bank loans and taxes, according to US Embassy contacts. Beijing, therefore, has been forced to reimpose price controls on

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some products and tighten restrictions on how state enterprises can use their retained earnings. [REDACTED]

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Despite the recent backtracking on price reforms, Deng Xiaoping, Acting General Secretary Zhao Ziyang, and other reform leaders remain firmly committed to using market mechanisms to drive China's modernization. We believe that reformers would like to implement a series of related market-oriented policies that are especially contentious within the leadership:

- Reformers would like to **expand markets for labor, capital, and raw materials** so that state enterprises could compete on an equal basis and be less dependent on upper level economic bureaucracies for supplies. They also would like a **bankruptcy** mechanism to establish market accountability for state enterprises.
- Reformers argue that the state should **lease or sell small state enterprises**, particularly those sustaining losses, to individuals. This not only would ease the government's subsidy burden but would make the factories more responsive to market forces. Moreover, they view the expansion of private enterprises as a means of absorbing surplus labor.
- Reform leaders call for **further commercialization of agriculture**. Recent articles in the Chinese press argue that, to boost grain production, Beijing should hike procurement prices and continue to reduce the amount of grain peasants must sell under contract to state supply units. [REDACTED]

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### Looking Ahead

Senior Chinese officials have told the US Embassy that China has reached a critical juncture in its reform program. They believe that, because living standards have risen rapidly since 1979, workers still strongly support reform. But these officials fear that support will erode unless Beijing can check inflation and corruption. Some Chinese bureaucrats, for example, are exploiting loopholes in reform policies by using their connections to purchase goods at low in-plan prices and resell them at much higher market prices. Public cynicism toward reform reportedly has begun to grow because many of the people involved are the children of senior officials. [REDACTED]

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Deng and Zhao have publicly asserted that the 13th Party Congress will signal a new phase in China's economic reform effort. They claim that the Congress will approve new ideological guidelines sanctioning market-oriented policies and that Beijing will hasten implementation of reforms later this year. However, we believe that, because of the sharp split among senior officials over economic policy, the Congress is unlikely to provide a detailed account of how Beijing plans to proceed with reform. Moreover, the Congress probably will couch its policy pronouncements in rhetoric that reaffirms China's long-term commitment to socialism, thereby watering down its endorsement of market mechanisms. [REDACTED]

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Thus, despite Deng and Zhao's upbeat rhetoric, a cautious agenda for 1988 is likely. In a speech at a national planning conference last month, a senior conservative spokesman on economic policy argued that Beijing must implement an austerity program for several years and focus reform on improving enterprise operations--such as expanding the use of enterprise contracts. Senior Chinese economists have admitted to US Embassy officers that getting state factories to sign performance contracts with supervisory bureaus will be the focus of reform next year. Some of these economists view the contract system as a lowest-common-denominator policy that runs the risk of backtracking on previous reforms because it rewards the bargaining skills of factory managers rather than their responsiveness to market forces.

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In our view, Beijing's response to economic problems this year may have set the reform program back in another way. By treating the symptoms of China's economic problems--excessive investment spending and price hikes--rather than attacking the disease--lack of accountability to market forces--Beijing probably has delayed reaching the point when it will have adequate monetary and fiscal tools to moderate the strong demand pressures generated by relaxed central controls.

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#### **Status of Key Chinese Industrial Reforms**

**Enterprise Management Reform.** Beijing is implementing "enterprise responsibility systems" in which factories are granted operational autonomy but are held responsible for their own profits and losses. Beijing admits that these have been established in only about one-half of state enterprises, and that bureaucratic interference in operations is still extensive. Nevertheless, factories now retain a larger share of revenues, have greater discretion over how they are used, and can market overquota production at "negotiated," above-plan prices.

- Debate continues over the role of party secretaries in factories and how to prohibit excessive investment spending and wage hikes.

**Price Reform.** Because many prices are little changed from the 1950s, they do not reflect supply and demand or the costs of production. Chinese leaders realize that forcing enterprises to react to price signals will not improve resource allocation if prices do not transmit accurate information about relative scarcities. Therefore, in the past three years, Beijing has decontrolled prices of nonstaples, such as vegetables and meat; some durable goods, including bicycles and refrigerators; and minor consumer goods.

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- Leaders are concerned that price reforms, which have contributed to bouts of inflation, may stir public discontent. They differ over whether to administratively adjust prices or to relax state controls to effect price reform.

**Labor Reform.** Beijing plans to boost labor productivity by rewarding initiative with higher wages and by allowing workers increased say in job placement. Last fall, Beijing established guidelines for hiring new workers on fixed-term contracts that, if followed, would end lifetime job guarantees for employees in state enterprises. Most managers are still unable to fire unproductive workers, however, and they maintain labor harmony by offering across-the-board bonuses.

- Large state enterprises are entirely responsible for housing, education, health needs of their workers. Because local authorities object to bearing these costs if workers are laid off, Beijing continues to guarantee full employment.

**Bankruptcy Reforms.** Reform leaders want to increase productivity and financial accountability for state enterprises. Last December, Beijing approved trial bankruptcy regulations but implementation has been blocked by political infighting.

- Orthodox officials believe these reforms are inconsistent with socialism. Others argue that managers should not be held accountable for losses as long as the price system is irrational and factory decision making is subject to bureaucratic interference.

**Ownership Reforms.** Last year, Beijing conducted limited experiments with leasing small factories to individuals and allowed a few enterprises to issue shares to their workers.

- Conservatives strongly oppose allowing state enterprises to issue shares to workers and believe that private enterprise should be strictly limited.



**DIRECTORATE OF INTELLIGENCE**

23 October 1987

**China: Foreign Trade in 1987** [REDACTED]

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**Summary**

China will post its fourth consecutive trade deficit in 1987, but higher exports and reduced imports will probably shrink the deficit to \$4 billion, one-third the 1986 level; US statistics indicate that China will probably have a \$3.5 billion surplus with the United States. Major trade reforms under discussion in 1986 were put on hold earlier this year, but we expect debates over how to ease the burden of state subsidies to the trade sector to intensify in 1988. Beijing is considering a variety of proposals, including a currency devaluation, new tax incentives structured to encourage exports of manufactured goods, and other domestic price and enterprise reforms that will increase the financial accountability of export-producing enterprises. [REDACTED]

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### Trade Performance in 1987

After a rocky start this year, with China's foreign exchange reserves dipping below the politically sensitive \$10 billion level in January, China's trade sector has shown an impressive recovery. Policies geared toward promoting exports and curbing imports have proved effective, the current account deficit has improved, and foreign exchange reserves have risen. [REDACTED]

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**Exports.** In the first nine months of the year, Chinese exports grew 24 percent to \$26.5 billion, according to Chinese Customs statistics.<sup>1</sup> Significant gains have come from the textile sector, where garment shipments increased 33 percent in the first eight months. Sales have tapered off somewhat in the second half of the year, with the filling of textile import quotas in many Western countries. Even so, Beijing has demonstrated extraordinary flexibility in switching from garments in filled categories to new products, as well as in shifting the final stages of garment construction to offshore facilities in such countries as Jamaica and the Northern Marianas Islands. As a result, textile exports will probably continue to grow at a modest pace through the end of the year. [REDACTED]

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Regarding other categories of goods, rising oil prices have helped boost Chinese export earnings from last year's depressed level. Gains have been made in exports of nonferrous metals and coal as well. Exports of grains and raw cotton, however, have declined by 25 and 30 percent respectively because production has not kept pace with the increasing domestic demand for these commodities. [REDACTED]

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**Imports.** Chinese statistics indicate that in the first nine months of the year imports declined nearly 4 percent to \$29.2 billion. China's purchases stagnated in 1986 as a result of tightened procedures for allocating foreign exchange and closer monitoring of purchases to avoid duplication. This year's decline results primarily from a ban on most new import contracts imposed in February. Imports of timber, synthetic fiber, iron ore, rolled steel, and aluminum fell by more than one-fifth in the first eight months of 1987 compared with the same period in 1986. Sharp increases in imports of grains and chemical fertilizers--up 54 and 177 percent respectively--have muted the impact of the contract ban, however. Beijing is concerned about its lagging agricultural output, and in 1987 will very likely become a net grain importer for the first time since 1984. [REDACTED]

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Another factor that has muted the impact of the import ban is the time lag between contracts and deliveries. Chinese Customs statistics record shipments rather than contracts, and shipments of items contracted for before February have continued. But, by the same token, import shipments will probably remain sluggish for several months after the ban is lifted, which we believe could occur later this year or in early 1988. [REDACTED]

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<sup>1</sup> Except as otherwise noted, trade statistics used in this paper are from Chinese Customs. [REDACTED]

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**Trade Balance.** We estimate that last quarter, for the first time in three years, China had a small surplus in its merchandise trade balance. A monthly merchandise trade surplus was posted in June, July, and August, and September's imports and exports, net of services, were roughly equal. Although Beijing will probably record its fourth consecutive trade deficit this year, the drop in imports and a surge in exports will probably shrink the deficit to roughly a third of the \$12 billion posted in 1986. [REDACTED]

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**Foreign Exchange Reserves.** Improvements in China's current account were largely responsible for a \$2.7 billion surge in China's foreign exchange reserve holdings from January through June, the last month for which data are available, to \$12.6 billion. China's state-held reserves also increased modestly, from \$2.1 billion to \$3.4 billion during the six-month period. [REDACTED]

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Total trade will probably exceed \$70 billion by yearend, but may fall short of last year's level of \$73.8 billion. If so, it will be the first time since 1982 that China's total trade has failed to increase. [REDACTED]

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In the first eight months of 1987, as in 1986, China's top five trading partners were Hong Kong, Japan, the United States, West Germany, and the Soviet Union. Japan dropped from first to second place, however, probably for a number of reasons: Beijing has mounted a concerted effort to curb purchases of consumer goods and motor vehicles, for which Japan is the major supplier; and China has deliberately sought to diversify trading partners as well as "punish" Japan for its large trade surplus with China by directing purchases to non-Japanese suppliers. China continues to hold its largest bilateral trade deficit with Japan, but we expect Beijing will be able to narrow the gap from \$7.7 billion in 1986 to about \$4 billion in 1987. [REDACTED]

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Although Sino-Soviet trade has grown rapidly since the signing of a bilateral economic accord in July 1985, trade between the two countries may decline slightly in 1987, in part because China is unhappy with the quality of Soviet technology and equipment being offered for a number of joint renovation and construction projects agreed to in principle in 1985. [REDACTED]

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### Sino-US Trade in 1987

Chinese and US bilateral trade statistics vary widely, primarily because of differences in the way the countries tally shipments through Hong Kong and other third countries.<sup>2</sup> The United States counts transshipments by their country of origin and their

<sup>2</sup> Although discrepancies frequently exist in trade partner data, the United States is the only major trading partner for which Chinese statistics have shown consistently higher figures for imports and lower values for exports. Besides differences in the recording of transshipments, the countries use different methods to determine the value of traded goods, varying in the inclusion of insurance and some transportation expenses. Differences in currency-conversion ratios and in the accounting methods used for leased equipment and service payments, as well as time lags in recording trade flows, have contributed to the discrepancies. [REDACTED]

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final destination. China, in contrast, records US-bound exports shipped through Hong Kong as exports to the colony, and enters US-origin imports shipped through Hong Kong as purchases from the island. Discrepancies in trade statistics are growing, because a larger share of bilateral trade is being shipped through Hong Kong in 1987 than in 1986:

- In 1986, according to Chinese Customs statistics, China had a \$2.1 billion deficit with the United States. Projections for 1987 indicate a \$1 billion Chinese deficit with the United States is likely. Moreover, Chinese statistics suggest that total bilateral trade will drop from \$7.3 billion in 1986 to \$6.4 billion this year, primarily because of a drop in Chinese purchases of US goods.
- In contrast, US statistics indicate that the more than \$2 billion imbalance was actually a Chinese surplus, and projections based on US statistics suggest a \$3.5 billion Chinese surplus for the year. US figures also project that bilateral trade will increase from \$8.4 billion in 1986 to roughly \$9.7 billion in 1987, and that stepped-up Chinese exports to the United States account for most of this growth. [redacted]

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US imports from China are heavily concentrated in relatively few categories of goods. US statistics indicate that clothing and textile yarn and fabrics made up nearly half of US purchases in the first half of 1987. US exports are less concentrated, but the top three categories--aerospace equipment, fertilizers, and grains--nonetheless accounted for about 30 percent of US sales during the first seven months of the year. China's imports of US grains increased sixteen-fold during the period, while purchases of fertilizers more than quadrupled. [redacted]

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### China's Evolving Foreign Trade Regime

Beijing's management of foreign economic relations has prompted considerable debate in recent years. Arguments between conservative and reform-minded Chinese officials over trade administration have centered on the appropriateness of central versus local control, and the use of administrative controls--licenses and quotas--versus economic levers such as tariffs and prices. As a result, changes in China's trade structure have tended to occur fairly frequently, and the current system is a hybrid that combines elements of central and decentralized administration. Direct controls and indirect levers also operate simultaneously. For example, in recent years Beijing has expanded the use of licenses and quotas to regulate exports of products that are subject to Western restrictions and to curb Chinese imports of nonessential consumer goods and equipment that can be produced indigenously. At the same time, it has experimented with adjustments to Customs duties, prices, and foreign exchange and tax remittances by exporters and export-producing enterprises. [redacted]

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Concerns about the level of China's foreign exchange reserves prompted Beijing to stiffen central controls over foreign exchange allocation, contract signing, and foreign borrowing in early 1987. Reforms of the country's foreign trade system that had been

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[redacted]

under discussion in 1986--which would have increased the autonomy of Chinese trade corporations while making them accountable for foreign exchange profits and losses--were put on hold. In place of the broader trade reforms, Chinese leaders began to discuss implementation of the "contract management responsibility system," under which trade corporations would sign annual agreements with the Ministry of Foreign Economic Relations and Trade (MOFERT) specifying the foreign exchange the corporation would be expected to earn, as well as the portion to be turned over to the Ministry. [redacted]

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Many Chinese trade officials, however, view the contract system as at best an interim measure that forces MOFERT to shoulder the burden of gaps between international prices and irrational state-set domestic prices, and we believe that favorable trade figures for yearend 1987 will rekindle discussions of how best to reform the trade sector. We expect that debates next year over foreign trade management will focus on how to ease the burden of state subsidies to the trade sector, which have contributed to the increase in China's budget deficit. Indeed, the shift has already become apparent in discussions US diplomats have held with Chinese trade and finance officials, as well as in articles appearing in the Chinese press. [redacted]

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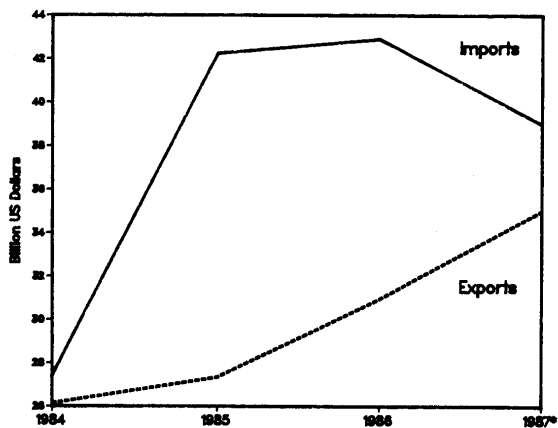
According to diplomatic reporting, officials from China's Ministry of Finance and the People's Bank of China advocate currency devaluation to narrow the gap between domestic and export prices. Their views have been countered by other economists who contend that a devaluation would merely shift subsidies from exports to imports, since state subsidies would be needed to soften the impact of higher import prices for essential items. Instead of a devaluation, MOFERT advocates the replacement of subsidies--which tend to encourage exports of primary products--with a system of tax incentives structured to encourage exports of higher value-added goods. Under the proposed tax system, the state would still bear the costs of the irrational domestic price structure, but it would be encouraging exports of items whose domestic prices more closely approximate international levels. Beyond tax reforms, MOFERT officials have also been strong proponents of domestic enterprise and price reforms, arguing that without them efforts to make foreign trade corporations responsible for their profits and losses will fail. [redacted]

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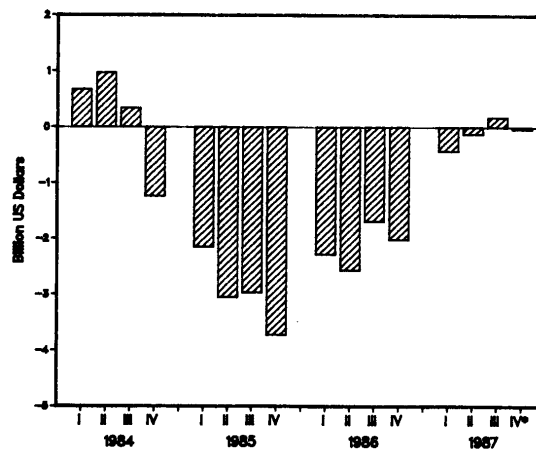
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## China: Trade Trends, 1984-87

Exports and Imports

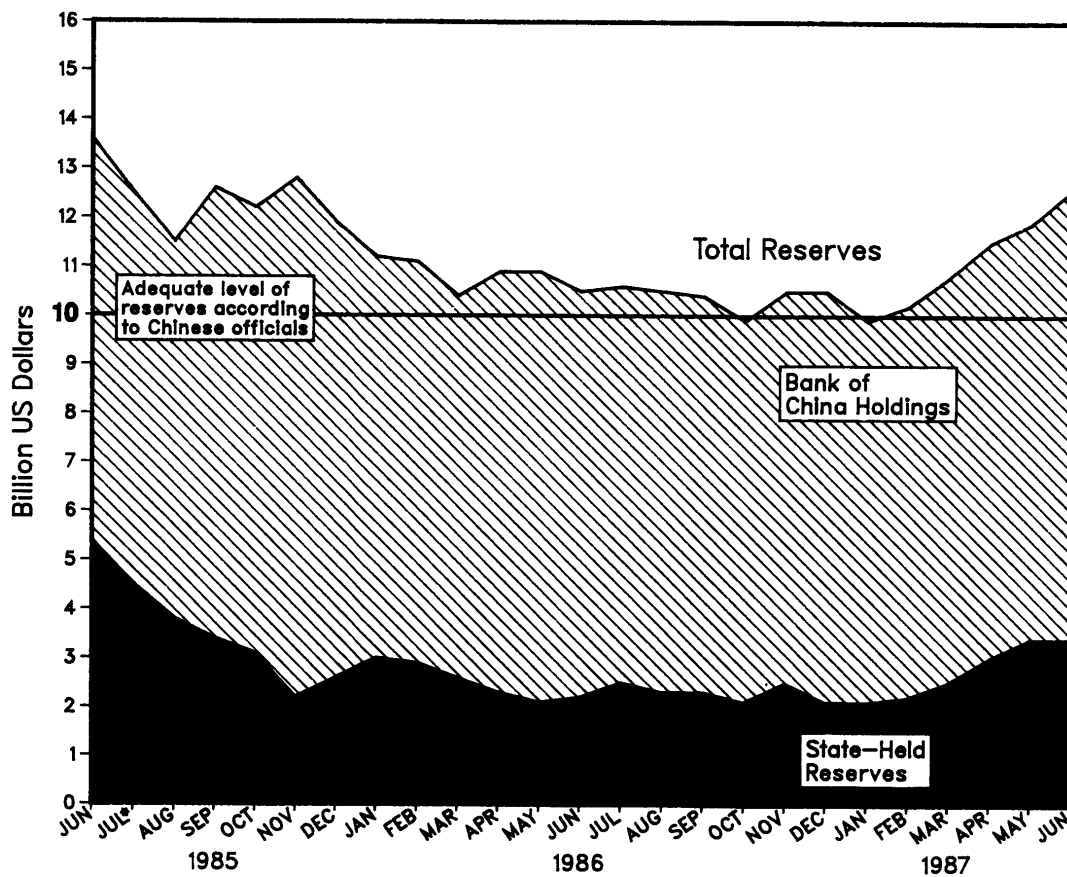


Quarterly Merchandise Trade Balance



\* Projected.

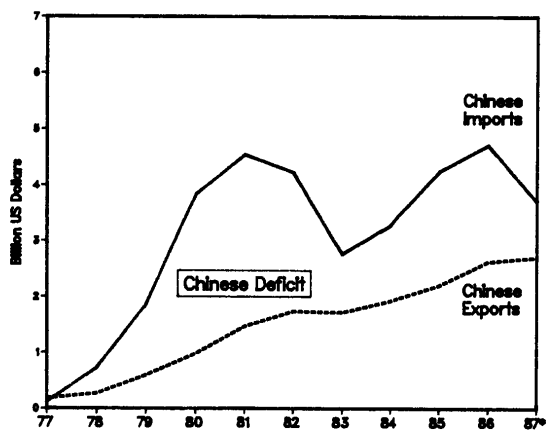
### China: Official Foreign Exchange Reserves, 1985-87



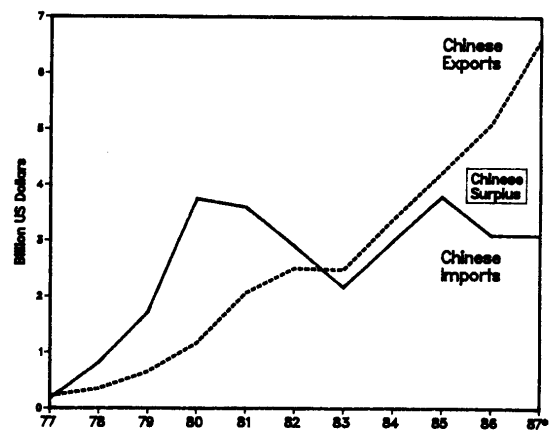
\* Estimated.

## China-US Trade, 1977-87

Chinese Statistics



US Statistics



\* Projected.



**DIRECTORATE OF INTELLIGENCE**

23 October 1987

**China's External Debt**

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**Summary**

From 1983 to 1986 China nearly tripled its foreign debt to \$25 billion, according to International Monetary Fund (IMF) estimates. Beijing, however, does not have a consolidated record of its borrowings. Indeed, the government only recently expanded the responsibilities of the State Administration for Exchange Control to include estimating the debt and monitoring and regulating all foreign borrowing.

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Our own research suggests that the debt may be slightly higher than the IMF figures. Much of it is in costly short-term loans or denominated in yen--a currency that has appreciated against the yuan 175 percent in the last three years. Beijing has sought advice from Western financial experts on how to improve its borrowing strategy and plans to lower borrowing costs by relying more on concessionary loans. But because of competition for concessionary loans among developing countries, we believe that Beijing will have to rely increasingly on

This memorandum was prepared by [redacted] Office of East Asian Analysis. Information available as of 22 October 1987 was used in its preparation. Comments and queries are welcome and may be directed to the Chief, Trade and Technology Branch, China Division, OEA, [redacted]

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commercial loans--including those from the United States. Although China's borrowing may dip slightly this year from the \$5.6 billion of 1986, we believe it will return to at least that level in 1988 judging from Beijing's plans for modernization. [REDACTED]

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We believe that China's debt is well within serviceable limits. China's low, 15- to 20-percent debt service ratio is favorable when compared with those of other developing nations. To maintain this favorable credit rating as the debt grows, however, Beijing will have to follow through effectively with its plans to more closely monitor its foreign obligations. [REDACTED]

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### Recent Trends

In the past three years, China has experienced an unprecedented rise in its overseas debt, which reached nearly \$25 billion at yearend 1986, according to IMF estimates (see table 1). The rise largely resulted from trade liberalization instituted late in 1984 that allowed some enterprises and local governments to buy foreign goods and to borrow overseas directly. Local authorities turned directly to foreign banks to finance the burgeoning trade deficit that resulted, and outstanding bank debt more than doubled in 1985 alone. [REDACTED]

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By late 1985, Beijing had serious concerns about the rapid rise in debt. Much of the increase, [REDACTED] had been in costly short-term debt that required frequent rollover. Further, we believe that over half was denominated in yen, which was appreciating against the yuan, making the loans much more expensive to repay. Accordingly, the Seventh Five-Year Plan (1986-90), approved in early 1986, called for less foreign borrowing and more centralized control over foreign exchange and foreign loans. Earlier this year, IMF officials warned Chinese officials that China's "external debts are no longer light, its debt structure is irrational, and its debt management is not well coordinated." [REDACTED]

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Table 1  
China's Growing Debt

Billion US \$

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		Chinese Estimates	IMF Estimates
1983	Short term	6.4	5.6
	Long term	0	4.0
	Total	6.4	9.6
1984	Short term	5.9	6.3
	Long term	1.3	6.7
	Total	7.2	13.0
1985	Short term	9.4	10.4
	Long term	6.4	8.9
	Total	15.8	19.3
1986	Short term	3.7	5.4
	Long term	17.0	19.5
	Total	20.7	24.9

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### Profiling China's Debt

China's official reports of its foreign debt have consistently been lower than Western estimates. At yearend 1986 the official Chinese estimate was \$20.7 billion, while estimates from Western banks and international financial organizations ranged from \$24.9-28.1 billion. We believe the debt lies closer to the upper range of the Western estimates. Available data also indicate that the People's Bank of China's statistics have understated short-term trade credits, the liabilities of overseas branches of the Bank of China, and loans to Sino-foreign joint ventures.<sup>1</sup> Chinese statistics also do not fully reflect recent exchange rate adjustments and thus significantly undervalue China's sizable yen-denominated debt. With the compartmentalism of the Chinese bureaucracy, in any case, Beijing does not have a consolidated record of all the

<sup>1</sup> The People's Bank of China acts as the nation's central bank, with responsibility for functions such as controlling the money supply and monitoring foreign exchange. The Bank of China is the nation's specialized foreign exchange bank, authorized to engage in foreign exchange transactions and international account settling for foreign transactions.

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borrowings of its regional and state agencies. [REDACTED]

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**Composition of the Debt.** Because Beijing strives to keep the cost of borrowing as low as possible, we believe China's borrowings at concessional rates may be as much as one-quarter of the total. China has received Overseas Development Assistance (ODA) loans or trade credits from 17 nations. ODA disbursements are slow, however, and less flexible than commercial loans, because they are usually tied to specific infrastructure projects and, sometimes, to specific suppliers. Even on commercial loans, Chinese borrowers press foreign banks for interest rate concessions or for help in arranging offsetting countertrade deals to reduce their hard currency repayment obligations. Most foreign lenders have been slow to accept these conditions. [REDACTED]

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Bonds have been a growing source of funds for China. Since 1982, Chinese borrowers have raised almost \$2 billion in Tokyo and other Asian bond markets, but have made little headway in tapping bond markets outside Asia (see table 2). Until recently, China was blocked from using the London and US capital markets because of its refusal to honor foreign debts incurred before the overthrow of the Nationalists in 1949. However, in June Britain signed an agreement with China settling its historical claims, and last March a US court decision cleared the way for China to borrow in the United States. In late September, the Bank of China (BOC) issued bonds worth \$200 million in London. This may have been a way of testing the waters before a commitment in the US market. Although bonds are not required to be rated in the London market, Beijing may be hoping that sales there will indicate probable future ratings in the United States. China's access to the US and London financial markets, which are the world's largest, will help it diversify its bonds away from yen--a currency that has appreciated against the yuan 175 percent in the last three years. [REDACTED]

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Chinese financial institutions are also experimenting with new forms of raising capital:

- Chinese banks in Hong Kong have issued certificates of deposit (CDs) in Hong Kong dollars and US dollars.
- Enterprises have issued commercial paper in Hong Kong dollars and yen.
- Chinese banks have been underwriting Australian dollar CDs in Hong Kong. [REDACTED]

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In addition to over half of its debt being denominated in yen, China's borrowings have been largely short term. The IMF estimated at yearend 1985 that as much as 56 percent of China's debt was short term in contrast to 25 to 30 percent for most developing nations. The short-term debt was taken on during China's trade decentralization, as individual entities financed imports with 90-day paper, reportedly expecting the central government to pay when the loans came due. Although Beijing consistently had reserves worth three to six months of imports, it did not pay off the enterprises' debts, which then had to be constantly rolled over. [REDACTED]

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Table 2

## Chinese Bond Issues in International Markets

Million US \$

Date	Amount	Market	Currency
Jan 82	43.5	Japan	Yen
Aug 83	20.5	Japan	Yen
Nov 84	81.3	Japan	Yen
Jan 85	116.5	Japan	Yen
Apr 85	79.2	Japan	Yen
Jun 85	54.0	West Germany	Deutsche marks
Aug 85	38.5	Hong Kong	Hong Kong dollars
Sep 85	138.2	Japan	Yen
Sep 85	150.0	Japan	US dollars
Sep 85	51.0	West Germany	Deutsche marks
Nov 85	49.9	Japan	Yen
Dec 85	100.0	Japan	US dollars
Feb 86	213.0	Japan	Yen
Feb 86	133.0	Japan	Yen
Apr 86	278.4	Japan	Yen
Jun 86	200.0	West Germany	US dollars
Sep 86	51.3	Hong Kong	Hong Kong dollars
Sep 86	130.2	Japan	Yen
Nov 86	50.0	Singapore	US dollars
Dec 86	61.7	Japan	Yen
Apr 87	200.0	Singapore/Luxembourg	US dollars
Jun 87	69.2	Japan	Yen
Jul 87	50.0	Hong Kong	US dollars
Aug 87	99.3	Japan	Yen
Sep 87	200.0	United Kingdom	US dollars

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[REDACTED]

**Disposition of Borrowed Funds.** The Chinese generally allocate borrowed funds according to their source. Chinese officials have said that yen loans are generally tied to the energy and communications sectors; soft World Bank loans are spent for health, education, and agriculture; hard World Bank loans underwrite long-term infrastructure projects such as roads and dams; and bilateral loans from Europe are usually mixed credits and thus have to be spent in the creditor country. [REDACTED]

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Independent reporting on borrowing during 1986 supports this breakdown. Almost 60 percent was spent on energy-related projects, though yen loans were not the only source of funds for energy projects last year--half were supplied by France for the Daya Bay nuclear power plant. Most syndicated loans were spent on energy, although a portion went to finance such "nonproductive" projects as hotels, apartment complexes, and shopping centers. [REDACTED]

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We cannot identify the end-use for almost a third of 1986 borrowing. All of China's bond issues and the funds borrowed by the China International Trust and Investment Corporation (CITIC) and the Bank of China fall in this category. We believe a significant portion was used to refinance short-term obligations and lengthen the maturity structure of China's debt. [REDACTED]

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**Improving Debt Management.** To quantify China's indebtedness and help manage the debt, last year Beijing tasked the State Administration for Exchange Control (SAEC) with providing information on China's indebtedness. To create consolidated debt figures for China, the SAEC requested assistance from the IMF in designing a debt reporting system and linking that system to approvals of external borrowing. Beijing also asked for information on problems in other countries resulting from deficiencies in debt monitoring and control procedures. Regulations were recently published in China requiring borrowers to register all foreign debt and to open a special account for it in an approved bank by late September. However, some corporations may have missed the September deadline. The SAEC is also investigating institutions using foreign exchange, documenting the disposition of foreign exchange, and reporting violations of SAEC regulations [REDACTED]

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Meanwhile, organizations such as the World Bank and the New York Stock Exchange have given seminars in China to help Beijing improve its borrowing strategy. They emphasized practices not currently followed by Chinese borrowers such as diversifying markets, maturities, currencies, and instruments, and considering factors other than low interest rates. [REDACTED]

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Chinese officials responded by agreeing to consider refinancing their largely short-term, yen-denominated debt through some longer term, dollar-denominated borrowings, and during 1986 the proportion of China's debt that is short term is estimated by the IMF to have fallen to one-fifth. During the first half of 1987 the primary interest of the fund-raising department of the Bank of China has been the diversification of funding sources, according to Embassy reporting. The BOC has recently begun to focus on the US capital markets and the Euromarkets through London. In June, China announced its entry into the US market with a \$200 million syndicated loan, which was signed in mid-October 1987. Also in mid-October, Beijing offered \$200 million in bonds in the London market. [REDACTED]

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### Short Term Prospects for Borrowing

Beijing's efforts to reestablish control over foreign debt do not signify a shift away from foreign capital, in our estimation. A large portion of last year's budget deficit of \$2 billion--quadruple 1985's--was financed by foreign borrowing. This year's budget, presented by Finance Minister Wang Bingqian to the National People's Congress in March, forecasts an even larger deficit and proposes a doubling of foreign borrowing to help finance it. Although a temporary ban on imports and an improved balance of payments for 1987 may alleviate some pressure, the predicted budget deficit will probably offset much of these gains, causing China's rate of borrowing in 1987 to be nearly as high as in 1986.

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If Beijing has its way, China will increase the level and proportion of concessionary borrowing. In the March budget speech, Wang suggested that China might seek as much as \$3-4 billion in concessionary loans this year. According to diplomatic reporting, Beijing has asked Japan to speed up its Overseas Economic Cooperation Fund disbursements remaining in the 1984 to 1990 commitment, to grant more in its next loan package, and to move up the starting date of that package. Beijing has also requested increased World Bank assistance, and we expect it to do the same with the Asian Development Bank. But because China has exploited most of the available sources of concessional financing and faces fierce competition from other developing countries, significant increases in concessional lending will not be forthcoming. This suggests that commercial loans will account for most of the growth in China's foreign borrowing.

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### The Burden of Debt Service

China's debt service obligations are not a hindrance to future borrowing. Beijing officially claims that its debt service ratio stands between 8 and 10 percent, with the ratio calculated as the annual payment of principal and interest as a percentage of total export earnings. Foreign economists have estimated that it is in the range of 15 to 20 percent. Recently spokesmen for CITIC and the SAEC privately concurred when presented with that range. More important to international bankers than China's debt service ratio is its willingness to transfer resources to meet debt payments. For example, last year Indonesia's debt service ratio ranged up to 40 percent without problems, while international bankers considered India's 25 percent very high.

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Accordingly, we believe that China will make a concerted effort to use US financial markets and that the United States may become an increasingly important source for commercial borrowing in the next few years. CITIC is looking into the different financing options in the United States market. Though China technically entered the US capital market this year by signing a syndicated loan, China has not yet participated in the US bond market, primarily because of the lack of a

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[redacted]

US rating for BOC and CITIC bonds. It is a matter of some political importance to Beijing that the bonds receive a favorable rating. Another obstacle is the detailed information required by the Securities and Exchange Commission; we expect Chinese bankers to balk at supplying financial information not commonly disclosed in China. [redacted]

[redacted]

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If Beijing's borrowing policies do not change dramatically, we expect that China's modernization plans will lead to a rate of borrowing at least equal to--and probably exceeding--the \$5.6 billion level reached in 1986. A State Planning Commission (SPC) official stated that despite the improved current account, there has been no reduction in planned foreign borrowing, and in fact, for the next few years the pace of foreign borrowing will be faster. The SPC establishes annual and five-year foreign exchange borrowing targets, viewing borrowing not as a means of balancing external payments, but as a means of financing construction projects and of making up the shortage of domestic investment funds. Beijing will try to concentrate its concessional borrowings on large infrastructure projects in transportation, communications, and energy, and to use commercial loans for construction in export industries that generate foreign exchange. [redacted]

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